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Application of

Total Environmental Solutions, Inc.

For Approval of an Adjustment in Rates and Charges for Water and Sewer Services

Hearing Date: August 4, 2004

S. C. PUBLIC SERVICE COMMISSION
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UTILITIES DEPARTMENT

Docket No. 2004-90-W/S

Surrebuttal Testimony of
Sharon G. Scott
Audit Department

Public Service Commission of South Carolina

SURREBUTTAL TESTIMONY OF SHARON G. SCOTT

FOR

THE PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA

DOCKET NO. 2004-90-W/S

IN RE: TOTAL ENVIRONMENTAL SOLUTIONS, INC.

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND OCCUPATION.

A. My name is Sharon G. Scott. My business address is 101 Executive Center Drive, Columbia, South Carolina. I am an Auditor for the Public Service Commission of South Carolina.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY INVOLVING TOTAL ENVIRONMENTAL SOLUTIONS, INC.?

A. The purpose of my testimony is to address and explain the issues brought forth by the Company in its rebuttal testimony.

Q. PLEASE EXPLAIN YOUR COMPUTATION OF THE NEGATIVE RATE BASE OF ($61,980) AND THE ALTERNATE COMPUTATION OF THE RATE BASE.

A. The Rate Base of ($61,980) was computed as follows: Staff allocated the purchase price of $3,450,000 to the Mountain Bay systems based on the number of South

Carolina customers of 1,021 as compared to the total customers of 42,624. The allocated amount was $82,640 or 2.40%. To this amount Staff added rehabilitation and replacement costs for 2001 and 2002 of $80,361 and 2003 rehabilitation and replacement costs of $94,396 as provided by the Company during the Staff's audit. Staff then included the allocated portion of the plant from the corporate office. This amount totaled $12,181 and was computed by allocating the total corporate office plant of $501,319 to Mountain Bay water (1.23%) and to Mountain Bay sewer (1.20%). The $501,319 consisted of Office Equipment of $23,982, Facilities Equipment of $9,842, Transportation Equipment of $20,531, Computer Services of $62,447, SLECA Organization and Start-up Costs of $159,517, and the Corporate Office Building of $225,000. Staff included the allocated portion of the costs in the Company's rate base instead of the Company proposed Debt Service Costs. Total Plant in Service amounted to $269,578 less Contributions in Aid of Construction of $370,756 for Net Plant of ($101,178). The Contributions in Aid of Construction consists of $175,728 for 2002 and 2003 and cumulative tap fees of $19,300. Staff added Cash Working Capital of $39,198. Cash Working Capital was computed using the per book Operating and Maintenance Expenses adjusted for correcting entries, resulting in $313,584 times 12.5% for the Cash Working Capital allowance of $39,198. Using net plant of ($101,178) and adding Cash Working Capital of $39,198, Staff computed a negative rate base of ($61,980). See Surrebuttal Testimony Exhibit #1.

Staff computed an alternate Operating Margin using the information from the Company's Depreciation Study. The total computed Rate Base amounted to \$817,943. This computation included Net Tap Fees from inception of the system and net plant enhancement fees (formally referred to as Availability Fees) since the last rate case. However, Staff has recomputed the rate base to exclude the plant enhancement fees. Based on a South Carolina Supreme Court decision, these fees were not attributed to the utility and the utility did not receive any benefit from the fees collected by the previous owner. The recomputed Rate Base amounted to \$1,609,342. The rate base was computed using the Total Plant in Service from the Company's Depreciation Study of \$5,465,576, the 2003 plant additions of \$94,396 and Plant allocated from the corporate office of \$10,740, which is net of accumulated depreciation. Total Plant in Service amounted to \$5,570,712, less Accumulated Depreciation of \$1,719,663, and net Contributions in Aid of Construction of \$2,280,905 for a net plant amount of \$1,570,144. The net Contributions were computed using \$2,585,700 (3,978 services at \$650 each) less the Amortization of Contributions in Aid of Construction of \$656,251 plus plant enhancement fees for 2002 and 2003. To net plant of \$1,570,144, Staff added Cash Working Capital of \$39,198 for total Rate Base of \$1,609,342. <u>See</u> Surrebuttal Testimony Exhibit #1. If the Commission decided to use the rate base from the study, depreciation expense would be \$30,038 and allowable Interest Expense would be \$30,848. The resulting Operating Margins, which include Interest Expense, purchased water costs of \$2,321, and the contract operation expenses of $36,000, would be 23.51% for water, 24.93% for sewer, and 24.16% on a combined basis.

Q. PLEASE EXPLAIN THE DIFFERENCES POINTED OUT BY THE COMPANY IN STAFF'S ADJUSTMENTS.

A. The Staff will address the Audit Department's adjustments for which the Company does not agree:

Adjustment #4 – Tap Fees

The Staff considers tap fees of $19,300 as Contributions in Aid of Construction based on the NARUC Uniform System of Account # 271 where a Contribution in Aid of Construction is (1) Any amount or item of money, services or property received by a utility, from any person or governmental agency, any portion of which is provided at no cost to the utility, and which represents an addition or transfer to the capital of the utility, and which is utilized to offset the acquisition, improvement, or construction costs of the utility's property, facilities, or equipment used to provide services to the public.

The cost of providing a tap should be capitalized based on the NARUC Uniform System of Accounts in Account # 333 for water and Account # 363 for sewer for Services to Customers. Tap Fees are considered as Contributions in Aid of Construction and are subtracted for the Company's rate base since the tap fees are cost free capital to the company. If the Company has not capitalized these costs but included them in expenses, then the Company's expenses are overstated and these expenses should be removed and capitalized in the plant accounts. In addition, Staff's treatment of tap fees as Contributions in Aid of Construction does not prevent the Company from collecting the Commission-approved tap fee amount.

Staff Adjustment No. 6 – Direct Wages

The Staff did not include the Field Technician in its adjustment since it was not a known and measurable change. The Company has not yet replaced the employee and therefore Staff had no basis for making this adjustment.

Staff Adjustment No. 7 – Purchased Water Costs

Staff verified the test year (December 31, 2002) per book amount for purchased water costs of $67,168. Staff determined that there was no increase in the water rate charged by the Westminster Commission of Public Works for 2002 or 2003 and therefore no adjustment was made. However, since the Utilities Department Staff used the 2003 year-end customers to annualize revenue, Staff now proposes to include the additional $2,321 for increased water purchased for the customers added since the end of the test year at December 31, 2002.

Staff Adjustment No. 9 – Contract Services

The Contract Services expenses were for the daily operation of the wastewater treatment plant, lab work sample, transporting of monthly reports to DHEC and collection of water samples along with other maintenance work. These expenses were removed from operating expenses as proposed by the Company. Staff was unaware that Kace Environmental was under contract to provide certified operation of the wastewater treatment plant. Staff was told by the Company that these services were now being performed by in-house employees. However, Staff has examined the invoices provided by the Company for the monthly charges of $3,000 per month and verified the amounts to the 2003 general ledger. The Staff agrees with the inclusion of $36,000 for contract services for the operation of the Foxwood Hills Wastewater Treatment Plant.

<u>Adjustment No. 10 – Insurance Expenses</u>

The Staff supplied a considerable amount of detail in the direct testimony under adjustment # 10 but wishes to expand on some of the same areas to provide more detail. The Vehicle Insurance costs amounted to $214,081 of which .02222 or $4,757 was allocated to South Carolina Mountain Bay systems ($2,426 for water and $2,331 for sewer). The General Liability Insurance allocation included the allocation of Excess Liability of $53,063, Property and Casualty of $55,827, Pollution Coverage of $85,467 and General Liability of $47,292. For the Property and Casualty Insurance of $55,827, $1,225 was allocated to the corporate office which was based on the 2002 allocated amount of $910 of the 2002 premium of $41,475 (factor of 2.19%). The net amount for Property and Casualty insurance was $54,602. The total premiums for the General Liability Insurance adjustment totaled $240,424 of which $14,018 was allocated to South Carolina based on 1,721 customers or 5.83%. Of the $14,018, 30.04% or $4,211 was allocated to Mountain Bay Water based on 512 customers, 29.29% or $4,105 was allocated to Mountain Bay Sewer based on 504 customers, and 40.67% or $5,701 was allocated to the Lockhart operations based on 700 customers. The total Workers' Compensation premiums of

$152,899 were allocated to South Carolina using the allocation factor of .71374%, resulting in an allocation of $1,092 ($553 for water and $539 for sewer) for Mountain Bay water and sewer operations. The total adjustment amounted to $7,190 for water, $6,975 for sewer, and $14,165 for combined operations. The Staff basically used the same methodology as the Company for this adjustment. The differences are due to the following: The Staff used the actual invoice amounts for the premiums for the period covering December 2003 to December 2004 and the Company used estimated amounts; the Staff allocated a portion of the general liability insurance to the corporate office; the Staff allocated a portion of the general liability insurance adjustment to Lockhart based on customers and the Company only allocated 1% to Lockhart; the Company also allocated 1% of the remaining insurance expenses to Lockhart; and the Staff did not allocate Workers' Compensation to Lockhart.

Adjustment # 11

Allocation Factors

The Staff used the same methodology to compute the Affiliated Services Charges as the Company, with the exception of the Debt Service Costs and Facilities Costs. The differences in amounts are mainly due to the elimination of the 700 Lockhart customers from the computation of Allocation Factor No. 1 and Allocation Factor No. 2. The Lockhart system is a contract customer with little to no work done from the corporate office for Lockhart system. Only one bill is sent to the Town of Lockhart. The town of Lockhart keeps its own books and records for these customers. After removing the 700 Lockhart customers, Staff's Allocation Factor No. 1 amounted to 2.44% and Allocation Factor No. 2 amounted to 3.58% for the Mountain Bay Systems. The Staff also recomputed the factor used to allocate Operating Cost to 1.23% for water and 1.20% for sewer. The change in this factor was also due to the removal of the 700 Lockhart customers from the allocations. Mainly, the differences in the Staff's and Company's allocated amounts are the difference in the factors, and the disallowance of Depreciation Expense and the 5% and 20% coverage factors.

Corporate Office Space

The Staff did not include an operating expense for the facilities debt cost of the office building, but proposed to include a portion of the building costs allocated to South Carolina in the Company's rate base. See Surrebuttal Testimony Exhibit #1. Staff allowed $440 for the facilities operating costs. The Staff did not use the same methodology to compute the facilities costs as the Company, but used the total customers. Staff has recomputed this amount using the corporate office square footage and number of customers. Staff used recomputed factors No. 1 of 2.44% and No. 2 of 3.58% for a resulting amount of $383 instead of $440 allocated to the Mountain Bay systems. The difference in the amounts is immaterial.

Corporate Office Operating Costs

The difference between the Staff's amount of $634,538 and the Company's amount of $694,353 was $59,814. Beginning with the Company's amount of $694,353, Staff disallowed the 5% coverage charge totaling $33,065, disallowed depreciation expense totaling $64,740, and then added back $37,990 for a math error on Supporting Schedule No. 4, page 4 (Total Operating Costs should be $371,064). The net amount is Staff's computed amount of $634,538. The Staff disallowed the coverage factor since it is not a known and measurable change and as the Company stated the allowance is for the "possibility" of the non-recovery of affiliate operating costs. Staff disallowed depreciation expense since the Company has a negative rate base. See Surrebuttal Testimony Exhibit # 1. Staff used the same method as the Company for this allocation, but used the factors, without the Lockhart customers, of 1.23% for Mountain Bay water and 1.20% for Mountain Bay sewer.

Corporate Salaries, Wages and Benefits

The Staff used the same methodology for computing the Corporate Salaries, Wages and Benefits as the Company. However, Staff used its recomputed factors, without Lockhart, for Factor No. 1 of 2.44% and Factor No. 2 of 3.58% to compute the total South Carolina portion of $16,242 of the total wages of $720,136. Staff then used the allocation amount of 2.26%, ($16,242/$720,136) to allocate the payroll taxes of $60,729 and employee benefits of $86,148. The 2.26% should not be the equivalent of the Staff's allocation factors of 2.43% since this allocation is based on Allocation

Factors No. 1 and No. 2 which are computed based on state allocation of customers instead of total system customers.

Corporate Costs – Summary

The Staff has computed total facilities costs, operating costs, and salaries, wages, and benefits allocated to the South Carolina Mountain Bay systems of $35,413 based on the allocation factors computed by the Staff for the state allocation of customers as well as total system number of customers. While the Company advocates that these costs may be unreasonable on a stand-alone basis, the utility is not a stand-alone company and should benefit from the economies of scale of having a corporate office to handle customer billing, customer service, engineering, accounting, etc. in one location.

Adjustment # 12 – Rate Case Expenses

The Staff does not object to updating rate case expenses for this proceeding for known and measurable expenses supported by invoices.

Adjustment #13 – Depreciation Expense

Staff proposed to eliminate the per book depreciation expense of ($5,821) and computed an alternate operating margin using information from the Company's depreciation study. The Staff did not allow any depreciation expense since the Company had a negative rate base. Several components used to compute the negative rate base are discussed in the following sections.

Purchase Price

The Staff included rehabilitation costs and plant additions in Staff's computation of the Rate Base for South Carolina. See Surrebuttal Testimony Exhibit #1. Staff notes that the $20 million dollars for rehabilitation costs referred to by the Company is for all the systems, not just South Carolina. Of the $3,450,000 purchase price for the six (6) states, Staff included in the Company's rate base an allocated portion of the purchase price of $82,640. Staff makes reference to the NARUC Uniform System of Accounts for Account #114 - Utility Plant Acquisition Adjustments: "This account shall include the difference between **(a)** the cost to the accounting utility of utility plant acquired as an operating unit or system by purchase, merger, consolidation, liquidation, or otherwise, and **(b)** the original cost, estimated, if not known, of such property, less the amount or amounts credited by the accounting utility at the time of acquisition to accumulated depreciation, accumulated amortization and contributions in aid of construction with respect to such property." "The amounts recorded in this account with respect to each property acquisition shall be amortized or otherwise disposed of, as the Commission may approve or direct." Based on the NARUC Uniform System of Accounts, the Staff has proposed to only allow the Company the allocated purchase price for South Carolina. The Staff computed the allocated amount of $82,640 (2.40% X $3,450,000) based on the number of South Carolina Mountain Bay customers at December 31, 2002 of 1,021 and total customers of 42,624. The Staff asked the Company for its computation of the allocated purchase price to South Carolina and was not provided with this computation or any alternative method. Therefore, the Staff used the total system number of customers for the allocation. Staff has shown the effects of the "negative acquisition adjustment" on Surrebuttal Testimony Exhibit #1.

Contributed Property

Staff verified enhancement fees per book for 2002 of $175,728. Staff inquired to the Company about the amount of bad debts per books of $147,735 for water and sewer operations, but was not told that these bad debts were related to plant enhancement fees. Staff considers the amount of bad debt expense to be excessive and that the Company should take some type of action to make these collections. Staff does not propose to reduce the billed enhancement fees by these bad debts. In addition, Staff considers that Total Environmental Solutions Management Company of Louisiana has a very close relationship with the utility and that this company was established, among other things, to collect the enhancement fees. Before the establishment of Total Environmental Solutions Management Company of Louisiana, the utility company had the rights and benefits of the enhancement fee. It would be reasonable for the utility to continue to benefit from these enhancement fees since the lot owners who pay these fees have service lines which are maintained by the utility. In addition, the utility maintains a plant which has the capacity to serve several thousand customers which include these lot owners. Staff proposes to reduce the

Company's rate base by plant enhancement fees for 2002 and 2003 of $351,756 and for cumulative tap fees of $19,300, which are contributions in aid of construction.

<u>Adjustment No. 18 – Interest Expense</u>

The Staff does not propose to include Interest Expense since the Company has a negative rate base.

<u>Adjustment No. 21 – Income Taxes</u>

The Staff does not propose to include Interest Expense in calculating Income Taxes since the Company has a negative rate base.

Q. PLEASE EXPLAIN WHY THE STAFF DID NOT INCLUDE INSURANCE EXPENSE AND AFFILIATED SERVICES CHARGES ON AUDIT EXHIBIT A-3.

A. Staff used the Income Statement as labeled on a Per Book basis. The Staff did not include the Insurance Expenses and Affiliated Services Charges since these amounts were for pro forma adjustments. Staff has no objection to the inclusion of the proper level for these expenses.

Q. DID STAFF RECOMPUTE THE OPERATING MARGINS?

A. Yes. Staff recomputed the operating margins to include the additional purchased water costs of $2,321 and $36,000 for contract operation expenses. The resulting margins are 27.55% for water, 29.99% for sewer, and 28.68% for combined operations.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes, it does.

TOTAL ENVIRONMENTAL SOLUTIONS, INC.
RATE BASE EXHIBIT
FOR THE TEST YEAR ENDED DECEMBER 31, 2002

		Per Depreciation Study	Net Acquisition Adjustment		Allocated Purchase Price
		$	$		$
Plant In Service	**Note #1**	5,465,576		**Note #3**	82,640
2001 & 2002 Rehabilitations and Additions	**Note #2**				80,361
2003 Rehabilitations & Additions	**Note #2**	94,396			94,396
Allocated Plant From Corporate Office		10,740			12,181
Total Plant In Service		5,570,712			269,578
Less: Accumulated Depreciation		1,719,663			0
Less: Contributions in Aid of Construction		2,280,905			370,756
Net Plant		1,570,144	(1,671,322)		(101,178)
Add: Cash Working Capital		39,198	**Note #4**		39,198
Total Rate Base		1,609,342			(61,980)

Note #1 - The Depreciation Study includes the 2001 and 2002 Additions.

Note #2 - Rehabilitations and Additions per the Company's Depreciation Schedule provided during the audit.

Note #3 - The Purchase Price of $3,450,000 was allocated to South Carolina Mountain Bay systems based on 1,021 of 42,624 customers. The allocation is 2.39536% of $3,450,000 or $82,640.

Note #4 - Reflects the "Negative Acquisition Adjustment" - The difference between the net original cost plus additions and the net purchase price plus additions.